

# A Review of Unique Non-Employee Director Compensation Arrangements

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Executive Compensation Webinar Series  
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  - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail after this presentation

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## About Anthony “Tony” Eppert



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- Tony practices in the areas of executive compensation and employee benefits
  
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

## Upcoming 2021 Webinars

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- 2021 webinars:
  - Thoughts on Maximizing the Deductibility of Compensatory Arrangements (12/9/21)
  
- 2022 webinars:
  - Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program) (1/13/22)
  - Hot Compensation Topics (2/10/22)
  - Solving for the Tug-of-War Between Deferred Taxation and Long-Term Capital Gains (3/10/22)
  - [Topic TBD] (4/14/22)
  - Current Compensation Designs within Partnership Entities (5/12/22)
  - [Topic TBD] (6/9/22)
  - How to Effectively Vet and Hire a Compensation Consultant (7/14/22)
  - Navigating Compensation Rules Applicable to Financial Institutions (8/11/22)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/8/22)
  - Compensation Considerations Due to Upcoming Loss of EGC Status (10/13/22)
  - Aging Executive: Thoughts on Designing Succession Strategies (11/10/22)
  - [Topic TBD] (12/8/22)

Sign up here: <https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html>

## Our Compensation Practice – What Sets Us Apart

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- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human Resources
  
- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

## Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



# Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

## Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

## Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

## Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

## Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

## Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

## International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy



## Purpose of Program

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- The purpose of this program is to discuss unique ways to compensation members of the Board of Directors of a publicly traded company
- The problem from a presentation perspective, is that not many “unique” programs exist
  - Reason is likely due to the fact that director compensation design by directors is considered a “self-interested” transaction not subject to the business judgment rule defense
  - As a result, there is little reason for an issuer to be highly creative and unique in its director compensation design
- That said, there are a few unique arrangements
  - These are discussed on the following slides
  - Starting with certain background information to set the stage

## Background: Separate Equity Plan?

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- The equity plan scorecard (“EPS”) was adopted by ISS in 2015 and weighs the positive and negative factors around the following 3 pillars:
  - Plan cost,
  - Plan features, and
  - Grant practices
- As part of the “plan features” pillar, a certain number of points are allocated to the issuer if the equity plan has a minimum vesting feature
  - Full points within this bucket are awarded if the equity plan has a greater than 1-year minimum vesting schedule for all equity awards, subject to a 5% carve-out
  - No points within this bucket are awarded if the minimum vesting period is less
  - In total, 57 points are needed to pass (if S&P 500) and 55 points are needed to pass (if Russell 3,000)
- Frequently, non-employee director awards will contain a vesting schedule of less than 1 year (e.g., grants in arrears or vesting quarterly, etc.)
- As a result, and to help ease the strain on the 5% carve-out otherwise associated with both employees and non-employee directors receiving equity awards with vesting schedules of 1 year or less, consider moving non-employee directors to their own equity incentive plan
  - Noteworthy is that EPS does not apply to a non-employee director equity plan

## Background: Shareholder Ratification

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- Should shareholders approve all or a portion of non-employee director compensation (e.g., compensation caps, fixed formulas, etc.)?
- At a minimum, due to the decisions by the Delaware Supreme Court in *Seinfeld* and *Calma*, and as later narrowed by *In re Investors Bancorp, Inc. Stockholder Litigation* (December 2017), outside compensation advisers should be hired to help the board establish the fairness of their compensation
  - As background, directors’ decisions with respect to their own compensation can be challenged as self-dealing and are subject to the “entire fairness” standard (including both fair dealing and a fair price) rather than the more deferential and director-friendly “business judgment rule” (i.e., a boards’ decision will be upheld unless it cannot be attributed to a rational business purpose). That is, unless such decisions were ratified by the issuer’s shareholders
  - *Seinfeld* and *Calma* essentially stood for the proposition that the entire fairness standard of review would not apply with respect to equity awards to directors if the equity plan contained sub-limits (applicable to directors) that were both “meaningful” and approved by the shareholders (i.e., ratification defense). The end result is that the entire fairness standard would not apply if the teachings of *Seinfeld* and *Calma* are followed
  - However, *In re Investors Bancorp* held that the shareholder ratification defense would apply only if the issuer’s shareholders approved the specific equity awards in question or if the awards were pursuant to a self-executing (i.e., non-discretionary) formula in the equity plan that was previously approved by the shareholders
  - What should an issuer do?

## Background: ISS and Shareholder Ratification

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- ISS has a policy with respect to evaluating proposals seeking shareholder ratification of non-employee director cash or equity compensation
- Qualitative factors that will be considered include:
  - Director compensation compared to issuers with a similar corporate profile,
  - Any problematic pay practices with respect to non-employee director compensation,
  - The presence of any stock ownership guidelines (*i.e.*, at least 4x the annual cash retainer) or hold requirements applicable to non-employee directors,
  - Vesting schedules with respect to equity awards,
  - The mix between cash and equity compensation,
  - The presence of any meaningful limits on director compensation (*i.e.*, likely a result from *Seinfeld* and *Calma*),
  - The presence of retirement benefits or perquisites, and
  - The quality of the disclosure addressing non-employee director compensation
- The above last bullet is yet another reason why robust disclosure should be included within the narrative that directly precedes the Director Compensation Table of the proxy statement

## Background: ISS Pronouncement

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- Excessive director compensation
  - ISS has a policy to issue an adverse vote recommendation for board members responsible for approving non-employee director pay when the issuer exhibited a recurring pattern of excessive pay without a compelling rationale over a two or more consecutive years
  - ISS has updated its methodology to identify pay outliers
  - Under the updated methodology, a negative recommendation by ISS against the members of the board responsible for approving the offending pay could result if there is excess non-employee director compensation in two or more consecutive years without a compelling rationale or mitigating factors
    - Emphasis added because ISS is looking for a pattern of excessive compensation
  - To determine whether compensation is excessive, ISS will compare individual non-employee compensation to pay outliers

## Background: Action Items Surrounding Pay

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- Disclosure
  - Be robust (more than in prior years)
  - What is the philosophy associated with non-employee director compensation? How is the pay assessed? What is the frequency of the assessment? What is the process associated with any benchmarking?
- Benchmarking director pay and revisiting the determination as to the form and amount of such pay
- Whether director pay should be submitted to the shareholders for ratification

## Background: Characteristics of a Typical Package

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- Though amounts and types of director compensation are varied, there does exist a typical package
  - Form of compensation is typically a blend of cash and equity
    - Cash typically takes the form of meeting fees and/or annual retainers
    - Equity typically takes the form of fully vested restricted stock (granted in arrears at the end of the service period), or if not granted in arrears, then equity awards typically contain a short vesting schedule and take the form of RSUs (though options continue to be used by some company, they are less prevalent)
  - Entitlements and perquisites tend to be avoided
  - Cash typically takes the form meeting fees and/or annual retainer
    - Meeting fees are used to balance disparate workloads among members of the Board (e.g., one committee might be more active than another, and too, committee chairs tend to have heavier work loads)

## Background: Other Compensation

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- Related entity compensation
  - Typically, when an issuer has a private parent entity, then the director could receive compensation from both the issuer and the private parent entity
- Special equity awards to new directors
  - Though the practice varies greatly by industry, some issuers provide their newly minted directors with a sign-on equity award
- Mandatory deferrals of equity awards
  - Either through an actual deferral program, or via a stock ownership program
- Perquisites



## Treasury Stock Purchase Program

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- Consider implementing an elective program whereby non-employee directors elect to use their after-tax cash compensation to purchase treasury stock from the issuer
  
- Overview of the program
  - Cash compensation is deposited into a brokerage account;
  - Each director elects the percentage of the cash compensation that he or she will direct towards a FMV purchase of treasury stock (hopefully 100%, minus the monies to pay the taxes associated with the participant's receipt of the cash);
  - The brokerage shop executes the trade on the director's behalf, consistent with instructions, depositing treasury shares into their account and delivering cash to the issuer based on the FMV of the issuer's stock on the day the trade is executed (*i.e.*, no discount)
  - Brokerage fees could be paid by the issuer
  
- The issuer's cash outlay is essentially returned, except for the amounts used by the participants to satisfy their income tax liability
  
- Issues to consider include:
  - A plan document is required
  - A Form 8-K would be required
  - A Form S-8 covering the shares should be filed

## Treasury Stock Purchase Program (cont.)

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- [continued from prior slide]
- Advantages of a treasury stock purchase program include:
  - Shareholder approval is NOT required under NYSE and NASDAQ rules;
  - There is no draw from (or dependency upon) the share reserve of the equity incentive plan, thus such share reserve is preserved;
  - It encourages ownership in the issuer, thus serving the purpose of aligning the director’s interest with those of the issuer’s shareholders;
  - It can help to facilitate stock ownership requirements/guidelines, which can act as a mitigating factor to negate “materiality” in the risk assessment process;
  - It is more efficient than open market purchases since all directors would be able to satisfy their ownership goals on the same day rather than over an extended period of time (the latter of which could otherwise be required if there were low trading volume);
  - It is more equitable than director purchases in the open market because all directors will pay the same price (open market purchases could result in price disparity depending on when purchases take place);
  - Scheduling of purchases shortly after earnings release provides transparency and reduces risk of allegations that the participant used insider information; and
  - Issuances from treasury stock adds a small amount to the outstanding share count, which increases market cap (thus helping to satisfy ongoing listing requirements)

## Compensation to a Director's LLC

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- The situation arises in two common scenarios
  - Director is serving as the nominee of the LLC (e.g., a nominee of a large shareholder or private equity shop)
  - Director is the owner of the LLC, and in this scenario there are two types:
    - Director is the sole owner
    - The LLC has multiple owners (*i.e.*, another type of the nominee scenario)
  
- If the LLC has multiple owners, then:
  - Assigning income to the LLC will not likely work because the director will recognize income tax upon his or her receipt of the compensation under the “assignment of income” doctrine
  - The only exception to the foregoing rule applies in instances where:
    - The director does not control the LLC,
    - The director has only a minority equity position in the LLC, and
    - The director is serving on the Board as the nominee of the LLC
  
- If the director is the sole owner of the LLC, then:
  - The LLC would be considered a disregarded entity for tax purposes
  - As a disregarded entity, any payment of cash to the LLC would be treated as though the payment was made directly to the director
  - However, the payment of equity has a twist

## Compensation to a Director's LLC (cont.)

- Assume for this slide that the LLC is wholly owned by the director
- To get equity awards to the LLC, the award must first be granted to the director, and then the director could transfer the equity award to the LLC. This structure is necessary because:
  - Almost all equity incentive plans require equity award recipients to be natural persons
  - Form S-8 is only available for issuances to natural persons
  - Most equity plans contain a transfer restriction that prohibits a participant from transferring the equity award prior to vesting
  - Transfers from a director to his or her wholly-owned LLC would not trigger a Form 4 (i.e., his or her pecuniary interest has not changed)
    - However, future Form 4 and 5 disclosures should reflect that the director only has an indirect ownership in the shares that were transferred)
  - The compensation would be reported in the proxy statement without any reference to the LLC. Any subsequent transfer of vested equity by the director to the LLC would not have to be reflected in the proxy statement
  - The assignment of income doctrine would not be applicable because the director and the LLC are treated for tax purposes as one (i.e., the LLC is a disregarded entity)
    - Put another way, a taxpayer cannot assign to him or herself something that is already assigned to him or her under federal income tax laws

## Health Insurance

- Issuers have moved away from providing issuer-sponsored health insurance to its non-employee directors, but we still hear of the “ask” from time to time
- Problems with an issuer providing health insurance to non-employee directors include:
  - MEWA issues
    - Non-employee directors are considered self-employed
    - Adding them to the issuer-sponsored health plan creates a multiple employer plan
    - To eliminate discrimination issues due to excluding other independent directors, the plan would have to be amended to allow for “participating employers,” and as a result, MEWA status is created
    - If a self-funded MEWA, then ERISA preemption might not apply (though the Form M-1 that must be filed with the state would not likely be required because the number of participants does not exceed 1% of the total number of participants in the plan)
    - Without ERISA preemption, the plan is open to allegations that the plan has to comply with the funding requirements under state law Department of Insurance regulations
  - Disclosure in the non-employee director table of the proxy statement is not likely required unless access to such insurance is considered a perquisite
  - The stop-loss carrier should be notified since the class of those eligible to participate would have been expanded

## Don't Forget Next Month's Webinar

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- Title:
  - Thoughts on Maximizing the Deductibility of Compensatory Arrangements
  
- When:
  - 10:00 am to 11:00 am Central
  - December 9, 2021

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